SEC Proposes Pay Versus Performance Rule Under Dodd-Frank

On April 29, 2015, the Securities and Exchange Commission (the "SEC" or "Commission") proposed, by a 3-to-2 vote, a rule that would require companies to disclose, in any proxy or information statement for which compensation disclosure is required, a description of the relationship between executive compensation and financial performance of the company.[1] The proposed rule would add Item 402(v) to Regulation S-K[2] to implement Section 14(i) of the Securities and Exchange Act of 1934 (the "Exchange Act"), which was included in the Dodd-Frank Wall Street Reform and Consumer Protection Act. The SEC is seeking public comment on proposed Item 402(v), and the comment period ends on July 6, 2015.

I. Background

Section 14(i) provides:

> The Commission shall, by rule, require each issuer to disclose in any proxy or consent solicitation material for an annual meeting of the shareholders of the issuer a clear description of any compensation required to be disclosed by the issuer under [Rule 402 of Regulation S-K] (or any successor thereto), including, for any issuer other than an emerging growth company, information that shows the relationship between executive compensation actually paid and the financial performance of the issuer, taking into account any change in the value of the shares of stock and dividends of the issuer and any distributions. The disclosure under this subsection may include a graphic representation of the information required to be disclosed.

In its current form, Rule 402 of Regulation S-K requires disclosure of executive compensation, but it does not require disclosure of specific information showing the relationship between executive compensation actually paid and the financial performance of the registrant. The Compensation Discussion & Analysis (the "CD&A") required by Item 402(b) of Regulation S-K mandates disclosure of "all material elements of the registrant's compensation of the named executive officers." Section 14(i) supplements the information requirements of the CD&A, by requiring registrants to disclose in a clear manner the relationship between executive compensation and the financial performance of the registrant.

II. Proposed Item 402(v)

Item 402(v) of Regulation S-K, as proposed, would require a registrant to provide a clear description of (1) the relationship between executive compensation actually paid to the registrant's named executive officers ("NEOs")[3] and the cumulative total shareholder return ("TSR")[4] of the registrant, and (2) the relationship between the registrant's TSR and the registrant's peer group's TSR[5], over each of the registrant's five most recently

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[1] *See Pay Versus Performance*, Release No. 34-74835; File No. S7-07-15 (April 29, 2015), available at https://www.sec.gov/rules/proposed.shtml. Unless otherwise noted, all facts contained in this memorandum regarding the proposed rule are drawn from this release.

[2] 17 CFR 229.402.

[3] The NEOs disclosed in Item 402(v) are the same NEOs as defined in Item 402(a)(3) of Regulation S-K.

[4] The TSR disclosed for Item 402(v) is the same TSR value disclosed in the performance graph pursuant to Item 201(e) of Regulation S-K.

[5] The peer group used to calculate the TSR will be the same peer group as disclosed in the performance graph for purposes of

completed fiscal years. The SEC has indicated that it believes the proposed Item 402(v) disclosure would be helpful to shareholders in casting their vote on NEO compensation through the say-on-pay advisory vote under Exchange Act Rule 14a-21(a).[6]

a. Registrants Covered By Proposed Rule

Registrants subject to the proxy statement requirements of Section 14 of the Exchange Act would be subject to the proposed rule. Emerging growth companies, foreign private issuers and registered investment companies are excluded from the proposed rule, while business development companies are subject to the rule.

b. Proposed Rule

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Proposed Item 402(v) would require a table showing the executive compensation as disclosed in the Summary Compensation Table,[7] modified to (1) deduct the change in the actuarial present value of all defined benefit pension plans, but add back the actuarially determined service cost for services rendered by the executive during the applicable year,[8] and (2) exclude the fair value of equity awards at the time they were granted and add back the fair value of equity awards at vesting.[9] The SEC's adopting release indicates that an option's fair value would be included at vesting rather than at exercise because NEOs can choose when to exercise, which could distort the calculation. Item 402(v) disclosure also would require that executive compensation be presented separately for the principal executive officer[10] and as an average for the remaining NEOs.[11]

Item 201(e) of Regulation S-K or the peer group disclosed in the CD&A for purposes of Item 402(b) of Regulation S-K.

[6] Say-on-pay is an advisory vote that must be held at least once every three years to approve the compensation of NEOs as disclosed pursuant to Rule 402 at an annual meeting of shareholders at which directors are elected or for any meeting for which executive compensation disclosure is required.

[7] Item 402(c) of Regulation S-K.

[8] The portion of the change in actuarial pension value that results from changes in interest rates, executive's age and other actuarial inputs and assumptions regarding benefits that have been accrued in previous years would be excluded.

[9] To calculate fair value at vesting date for awards that vested in the applicable year:

(1) for awards of stock, fair value should be computed in accordance with the fair value guidance in FASB ASC Topic 718 at the date of vesting and

(2) for awards of options with or without tandem stock appreciation rights, fair value should be computed in accordance with the fair value guidance in FASB ASC Topic 718 at the date of vesting. A registrant would be required to disclose vesting date valuation assumptions if those assumptions are materially different from those disclosed in the registrant's financial statements as of the grant date.

If during the last completed fiscal year, the registrant adjusted or amended the exercise price of previously vested options or SARs held by an NEO or otherwise materially modified such awards, the registrant would need to include the incremental fair value, computed as the excess fair value of the modified award over the fair value of the original award upon vesting of the modified award. If a modified award is subject to multiple vesting dates, the pro rata incremental fair value would need to be determined and included in compensation actually paid at each vesting date. Using this methodology, compensation actually paid could be determined multiple times: fair value of original award at its vesting as well as any pro rata incremental fair value amounts at the vesting dates of the modified award.

[10] If there is more than one principal executive officer during the year, the compensation should be aggregated in order to provide an accurate description of the executive compensation provided for the individuals in that position.

[11] The proposed rule requires footnotes detailing the amounts that are deducted and amounts that are added to calculate the executive compensation actually paid.

Financial Performance

TSR would be the mandated metric for measuring financial performance. The registrant's TSR as well as the TSR of the peer group chosen by the registrant would both need to be disclosed in order to comply with the rule.

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As indicated above, companies would be required to disclose in a prescribed table (1) the executive compensation actually paid, (2) the company's TSR and (3) the peer group TSR for each of the company's five most recently completed fiscal years. Following the table, companies would be required to disclose[12] (a) the relationship between executive compensation and the registrant's TSR and (b) the relationship between the registrant's TSR and the peer group TSR. These relationships could be described narratively, graphically or using a combination of the two. The SEC has not proposed a specific location within the proxy or information statement for this disclosure. The proposed rule would require that a company disclose the requisite information for the fiscal years during which it was a reporting company, meaning that a new reporting company would only need to disclose that completed fiscal year's information.

The proposed amendment would be phased in. During the first year requiring disclosure under Item 402(v), a registrant would be required to disclose such information for the three most recently completed fiscal years. In the following year, the registrant would be required to disclose the four most recently completed fiscal years. For the subsequent years, the company would be required to disclose the five most recently completed fiscal years.

The disclosure required by Item 402(v) would not be deemed to be incorporated by reference into other SEC filings required under the Exchange Act or the Securities Act of 1933, unless the registrant specifically incorporates the disclosure by reference.

Under the proposed rule, the pay versus performance disclosure would be treated as filed in the proxy or information statements for Exchange Act purposes, which may create an incremental risk of litigation under Section 18 of the Exchange Act. The SEC is seeking comments on whether the TSR disclosure should be deemed to be filed for this purpose.

Smaller Reporting Companies

For smaller reporting companies, Proposed Item 402(v) would require disclosure of the relationship between executive compensation paid and TSR over the registrant's three most recently completed fiscal years instead of five years, and these companies would not be required to provide disclosure of peer group TSR. In order to phase in the disclosure requirements, in the first year a smaller reporting company is subject to Item 402(v) disclosure, it would be required to disclose only the two most recently completed fiscal years. For smaller reporting companies, NEOs would be those persons defined in Item 402(m). Smaller reporting companies would

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[12] This disclosure is subject to the plain English principles and is also required to be provided in tagged format using eXtensible Business Reporting Language ("XBRL"). The SEC stated they believe the use of XBRL would facilitate investor analysis of executive compensation and financial performance data across companies.

also not need to disclose amounts relating to pensions, and they only would need to use XBRL after their third filing with the pay- versus- performance disclosure.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Bradley J. Bondi at 212.701.3710 or bbondi@cahill.com; Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; Glenn Waldrip at 212.701.3110 or gwaldrip@cahill.com; David Slovick at 212.701.3978 or dslovick@cahill.com; or Sarah Turney at 212.701.3312 or sturney@cahill.com.